**Blakeley & Blakeley LLP**

# THE TRADE VENDOR QUARTERLY

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***Developments in Commercial, Creditors' Rights, E-Commerce, and Bankruptcy Law of Interest to the Credit and Financial Professional***

## *ESCHEATMENT: WHAT ARE YOU OBLIGATED TO REPORT TO THE STATE?*

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Is your corporation setting itself up to an unwanted or unclaimed credit audit? State regulator are enforcing escheatment laws more than ever today to offset budget shortfalls brought on by tax cuts, diminished fee collections and additional expenses associated with combating terrorism. If your company is not aware of the states' unclaimed property laws, or if they have largely ignored them hoping they would not get audited by the government - be aware as states are cracking down on enforcing escheatment laws today.

A corporation's duty to remit abandoned property to appropriate state authority is governed by the abandoned and dormant property laws of each state. How does a state's interest in abandoned property affect the credit professional? A credit professional often manages a portfolio of hundreds of commercial accounts, with credit extensions that can be in the millions of dollars. With an active trade relationship, it is not uncommon for the credit professional to have accounts with a surplus or credit balance. On occasion, the corporate customer may never claim the credit balance.

Are escheatment laws, or as commonly referred unclaimed property, a problem for the credit executive, especially where states are seeking untapped revenue sources to help offset budget deficits brought on by tax cuts and diminished fee collection? What is considered unclaimed property that may fall under the escheat laws? Does a credit balance qualify? What may be the consequence if the vendor declares the unclaimed property as income and applies it to the bottom line, as the vendor views it as a windfall to offset losses from unrelated delinquent accounts?

**Why is escheatment appealing to the State?**

Escheatment revenue is an appealing revenue source from the states' view as it does not require raising taxes. States are looking for sources of revenue, and abandoned property, as the press reports, may be that untapped source for states. For example, states collected over $20 billion in 2005 in escheatable funds.

**Escheatment Defined**

Escheatment includes all forms of property, both tangible and intangible, that becomes abandoned by its rightful owner. Common types of property are un-cashed checks, customer credit balances or refunds, security deposits, dividend check, corporate securities, insurance refunds or claims, and sometimes wages. Businesses and residents abandon over a billion dollars of tangible and intangible property annually. The purpose of escheatment laws is to reunite lost

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## *LIEN LAWS, BANKRUPTCY PREFERENCE LAWS AND PREEMPTION UNDER THE SUPREMACY CLAUSE OF THE U.S. CONSTITUTION*

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For contractors and materialmen doing business in the States of Colorado, Delaware, Illinois, Maryland, New Jersey, New York, Oklahoma, Texas or Wisconsin, payments under their state's lien laws may constitute payments from a trust. As such, the payments are arguably trust property and not property of a debtor, should the debtor file bankruptcy and seek return of the transfers under federal bankruptcy laws. But are the states' lien laws preempted by the Supremacy Clause of the U.S. Bankruptcy Code? This is the question faced by creditors who supplied services and equipment on construction projects in the Delaware bankruptcy case of *In re IT Group, Inc*.

In *In re IT Group*, two creditors, one a subcontractor and the other an equipment rental company, received transfers from the debtor-contractor within ninety days prior to the petition date. In response to the complaints filed against them, the creditors filed motions for summary judgment against the debtor asserting that the payments were from a statutory trust that the New York legislature had established for the benefit of parties providing labor, service and materials in connection with prime construction contracts. As such, the creditors asserted that the payments did not constitute an interest of the debtor in property, as required to constitute a preferential transfer.

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## *POST FILING DELIVERIES DO NOT ALWAYS PROVIDE "NEW VALUE" DEFENSE*

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As creditors know, the purpose of the affirmative defense of "new value" provided for in 11 U.S.C. § 547(c)(4) is to encourage creditors to continue their commercial arrangements with debtors who are in default. The creditor is rewarded for supplying goods or services, or extending credit voluntarily when it is under no obligation to do so. This is the crux of the "new value" defense. However, when the item must be shipped as a series of component parts for assembly at the debtor's premises, and debtor pays according to a schedule, what happens when the last payment is received during the 90-day preference period, and additional shipments are made thereafter?

That was the situation presented to the court in In re Globe Building Materials, Inc., 325 B.R. 253 (2005). Debtor is a manufacturer of roofing shingles and contracted with creditor to purchase a laminating machine in order to produce laminated shingles. The contract requires the debtor to pay the creditor according to a scheduled payment plan, and the creditor was to deliver identifiable component parts of the machine to debtor for assembly at debtor's premises. The payments however did not correlate with the shipments.

Creditor received debtor's last payment during the 90-day preference period, and shipped another component part during this time. Additionally, creditor sold and delivered certain spare parts to debtor, which debtor was billed $74,672.65. The trustee conceded that this amount was "new value" and thus not recoverable, but the trustee sought to recover $360,643.63 - the difference between the payments made to creditor during the preference period, $435,316.28, and the invoiced billing for the spare parts.

The question posed to the court was, were the component parts that were delivered during the preference period, subsequent to the preferential payment, afford the debtor "new value"?

*FROM THE PUBLISHER:*

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The creditor did not dispute that the payments were preferences, but contended that the payments were not recoverable based on 11 U.S.C. § 547(c)(2) and (c)(4). Section (c)(2) provides that the trustee may not avoid a transfer to the extent the transfer was in payment of debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee. To succeed, the creditor must prove by expert testimony that the payment was made in the manner customarily found in the industry. However, there was no evidence on record to sustain this affirmative defense.

Section (c)(4) provides that the trustee may not avoid a transfer to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor which was not secured by an otherwise unavoidable security interest and, on account of which new value, the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor. The burden of proof also falls on the creditor who must show that new value was given. Creditor must prove (1) creditor received a transfer which is otherwise voidable as a preference under § 547(b); (2) after receiving the preferential transfer, the preferred creditor advanced additional credit to the debtor on an unse-

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Guest Column

## *BANKRUPTCY PREFERENCE CLAIMS: HOW CREDIT PROFESSIONALS CAN AID IN THEIR DEFENSE AND MINIMIZE FURTHER LOSES*

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Many credit professionals have had the following experience during their careers:

*After struggling for weeks, or perhaps months to collect from a financially distressed customer, the customer ultimately files a petition in Chapter 7 or 11 bankruptcy.. The accounts receivable balance due from the bankrupt customer is subsequently charged off against the reserve for bad debt, a claim is filed with the bankruptcy court and the customer's credit file was placed in a file drawer marked "write offs," soon to be forgotten.*

*Almost two years later, the credit professional receives a notice from an attorney representing an Unsecured Trade Creditors Committee or Bankruptcy Trustee which demands repayment of all monies received from the bankrupt customer within the 90 days prior to the Chapter 11 petition filing date. The credit professional has just received a notice of an adversary preference action filed against his or her employer.*

At first glance, a preference claim against an unsecured trade creditor appears to be a case of "adding insult to injury." The unsecured trade creditor took the hit of a write off upon receipt of the notice of a bankruptcy filing by a customer. Then, two years later, the unsecured trade creditor receives notice that an adversary action (preference claim) has been filed to recover payments (transfers) made by the debtor within 90 days of the bankruptcy filing date.

Although the above scenario is fictional, it is based on the real personal experiences of credit executives. The frustration felt by credit professionals experiencing similar events is also real and stressful.

What is a credit professional to do to protect the assets of their company, you may ask? Actually, there are a number of factors

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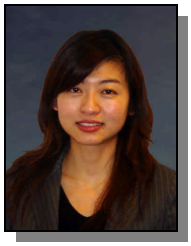
## *LONGSTANDING BUSINESS RELATIONSHIP MAY NOT PROVIDE A SAFE HARBOR TO VENDORS UNDER PREFERENCE EXCEPTION*



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A long-standing business relationship may allow a creditor to depart from the industry norm and still qualify for the ordinary course of business exception. However, instability in the relationship leading up to the debtor's insolvency will prevent the creditor from invoking this safe harbor, as demonstrated in *In re Terry Manufacturing Company, Inc. v. Bonifay Manufacturing, Inc.*

In *Terry*, the trustee brought an adversary proceeding to set aside debtor's preferential payment to the supplier, a sewing contractor. The companies began their business relationship when the debtor hired the supplier to produce shirts. The supplier relied heavily on the debtor for its continued existence in the garment industry during the economic downturn in the mid-1990s. The debtor had a history of making its payments late. The time between the invoice and date of payment ranged from 98 days to 321 days. The supplier allowed payments so late because it depended on the debtor for business and their long-standing business relationship.

Few months before the debtor filed a voluntary Chapter 11 bankruptcy, the debtor sent the supplier a letter setting forth a payment schedule asking for weekly payments to get current with the supplier. The debtor made these weekly payments for two months. In the ninety days preceding the Chapter 11 filing, the debtor made six payments to the supplier. These payments were made from 138 to 182 days after the invoice date.

The trustee instituted the action against the supplier to avoid the six payments. The sole issue on appeal was whether the bankruptcy court gave appropriate weight to the long-standing business relationship between the debtor and the supplier in determining whether the six payments were made in the regular course of business as defined by 11 U.S.C.A. §547(c)(2). Under this provision, a trustee may not avoid a transfer as preferential if the transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee; made in the ordinary course of business or financial affairs of the transferee; and made according to ordinary business terms.

The supplier satisfied the first two elements. The debt arose in the ordinary course of business because the debtor incurred the debts in exchange for sewing work. The supplier's decision to accept these six payments was in the ordinary course of business because the supplier regularly allowed the debtor to make payment substantially later than the invoice required.

However, as to the third element, the court adopted the three-step analysis set forth in *Molded Acoustical Products* in determining whether the transfer was made according to the ordinary business terms. First, the terms between the parties are compared to the range of terms on which firms similar to the supplier provide credit to firms similar to the debtor. Second, if the terms fall outside this industry norm, the court created a "customized window" which took into account the length of the business relationship prior to the debtor's insolvency. Finally, the court determined whether the relationship remained stable throughout the insolvency period. A relationship is not stable if terms of payment during the preference period vary considerably from the terms throughout the long-standing relationship or if the creditor had made effort to accelerate repayment.

The median for outstanding invoices in the garment industry is 39 to 55 days. In this case, the six payments made by the debtor to the supplier were 138 to 182 days past the invoice date, more than three times later than the industry standard. The supplier's departed from industry norm by more than 300% could be characterized as a gross departure.

Although there was a 18-year relationship between the debtor and the supplier, the relationship was not stable because there was no typical period of payment existed prior to or during the preference period. Payment were made from 98 days to 321 days after the invoice date prior to the preference period and 138 to 162 days after the invoice date during the preference period. The lack of typicality of payments

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## *NOTARIZE THOSE PERSONAL GUARANTYS TO AVOID LITIGATION*

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Credit professionals are well aware of the importance of documenting the credit sale to reduce the risk of customer disputes and defaults. Likewise, credit professionals are well aware that credit enhancements, such as personal guarantees, can be an effective tool to eliminate credit risk, especially where the sales force is eager to make the sale. While some may question the effectiveness of a personal guaranty in reducing or eliminating credit risk, a guaranty often creates an allegiance with the credit professional's company as opposed to a company shipping on open account without a personal guaranty. If the debtor company is not going to pay certain debts, the debtor's officer who has guaranteed the vendor's debt will likely direct those debts that are not personally guaranteed to remain unpaid. Instead, the debtor's officer may marshal the debtor's company's scarce financial resources to pay personally-guaranteed debt to avoid personal lawsuits for collection of the debt.

Recent decisions have underscored that in documenting the personal guaranty, the credit professional should insist that the guaranty be notarized to reduce the risk that the guarantor may raise as a defense to payment that the signature was forged. For example, in *Abernathy v. Weldon et. al.*, the vendor shipped on open account, based, in part, on the customer's president providing a personal guaranty. The guarantor faxed the guaranty to the vendor. The signature page was not notarized. The corporate customer failed to pay, and the vendor sued the guarantor. The guarantor challenged the vendor's collection lawsuit, contending that the signature on the guaranty was not his, that he did not give authority to anyone to sign the guaranty on his behalf, and that there were no witnesses to his signing the guaranty. Notwithstanding these defenses, the trial court entered judgment against the guarantor, observing that the signature appeared to be that of the guarantor.

The guarantor appealed, contending that the signature on the guaranty was a forgery. The guarantor offered a handwrit-

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# *SUPREME COURT REFUSES TO CONSIDER APPEAL RE THE STATE PREFERENCE ACTION: IS THE STATE PREFERENCE ACTION COOKED?*

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The United States Supreme Courts seems to appreciate that preference actions are the bane of the vendor, given the Supreme Court's recent decision to refuse to consider the appeal form. It seems that with any customer filing bankruptcy (no matter the bankruptcy chapter), vendors are targeted for payments received (or even goods that were returned by the customer) during the 90 days prior to the bankruptcy filing. A vendor may be surprised to find that a preference action is not limited to the federal bankruptcy system. Rather, over 20 states have also enacted state preference statutes. The effect of the state preference law is that if a customer does not liquidate its assets through a bankruptcy filing, but, rather, an out-of-court liquidation, such as an assignment for benefit of creditors ("ABC"), the vendor may still be sued for a preference pursuant to the state's preference law.

However, a state preference suit may now be barred under the doctrine of preemption and the federal bankruptcy preference. The US Supreme Court refused to consider the Ninth Circuit Court of Appeals decision, in *Sherwood Partners, Inc. v. Lycos, Inc.*,[1] that an assignee under an assignment for benefit of creditors ("ABC") statute does not have authority to pursue preference actions under California law. In that Ninth Circuit decision, the court ruled that the assignee had no such authority and ordered the preference action be dismissed. The court's ruling and its meaning to vendors is considered.

## A. *Assignment for Benefit of Creditors*

The ABC is a formal out-of-court liquidation where a fiduciary takes title to all of the debtor's assets and liquidates them for the benefit of the creditors. The ABC is pursuant to state law, and is an alternative to the federal Bankruptcy Code's Chapter 7 liquidation. Creditors are paid the proceeds in a manner similar to that established in the Bankruptcy Code.

The procedure for the ABC varies from state to state, with some states maintaining tight control over the process and others providing little regulation. Generally, the assignee is selected by the debtor. The ABC is comparable to an out-of-court Chapter 7 liquidation. However, an ABC does not require much financial disclosure, unlike a Chapter 7 filing, which requires schedules and statement of financial affairs to be filed. California's ABC law permits an assignee to sue vendors to recovery preference payments made within 90 days of the ABC.

### 1. States That Have Adopted the ABC

The following states that have adopted ABC's are Arizona, Arkansas, California, Colorado, Delaware, District of Columbia, Florida, Georgia, Indiana, Iowa, Kentucky, Rhode Island, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, North Carolina, South Carolina, South Dakota, North Dakota, Ohio, Oklahoma, Pennsylvania, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia and Wisconsin.

## B. *Background of Preference Laws*

Fundamental to insolvency law since its creation in the sixteenth century is paying creditors of the same class an equal percentage on their claims. This principle disfavors payments to one creditor at the expense of other creditors of the same class. Preference laws are central to this, and are the method to attempt to achieve the equality of distribution to creditors. The focus of preference laws has shifted from the culpability of the debtor, to the culpability of creditors, to the present day standard of strict liability; e.g. the vendor received payment within the preference period.

Preference laws seek to deter individual creditor action by threatening recapture of transfers made during the debtor's backslide into insolvency. In addition, it is believed that preference actions adhere to the policy of maximizing the insolvent estate.

### 1. The Bankruptcy Preference

The Bankruptcy Code vests the debtor (or trustee, or trust, if one is appointed) with far-reaching powers to recapture payments to creditors within the 90 days of the bankruptcy filing. The purpose of the preference provision is two-fold. First, unsecured creditors are discouraged from racing to the courthouse to dismember a debtor, thereby hastening its slide into bankruptcy. Second, debtors are deterred from preferring certain unsecured creditors by the requirement that any unsecured creditor that receives a greater payment than similarly situated unsecured creditors disgorge the payment so that like creditors receive an equal distribution of the debtor's assets.

The elements of a preference that a debtor must establish are:

(1) A transfer of property of the debtor;
(2) Transfer on account of an antecedent debt;
(3) Presumption of insolvency within 90 days of bankruptcy filing;
(4) Within 90 days (one year if an insider) before the filing of bankruptcy;
(5) That enables the creditor to receive more than it would have received in liquidation. The trustee, debtor or party assigned the avoidance actions, has the burden of proof to establish these elements.

Not all transfers made within the preference period are avoidable. To protect those transactions that replace value to the bankruptcy estate previously transferred, the Bankruptcy Code carves out seven exceptions or defenses to the trustee's recovery powers.

### 2. The State Preference Law

The states' preference statutory scheme generally operate the same as the bankruptcy preference statute. For example, in California, where the *Sherwood Partners* case state preference statute was examined, the preference statute is comparable to the bankruptcy preference statute. Vendors may assert defenses commonly raised in a bankruptcy preference, such as contemporaneous exchange, ordinary course of business and new value.

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owners with property that is rightfully their. Escheatment laws also protect the holder of abandoned property from subsequent claims by the owner after the property is transferred to the state. They ensure that any economic windfall goes to the state and not to the holder of the property. Escheatment laws provide that the state becomes the legal owner of abandoned property, based on the concept of state sovereignty. Of interest to the state is those businesses that have failed to escheat or turnover abandoned property to the state.

**Development of Escheatment Law**

The origin of escheatment law dates back to British law. Escheatment was originally used to describe the permanent transfer of abandoned land to the King of England. In the United States, the concept has been adapted to apply to tangible and intangible personable assets; since we have no king the assets go to the state government.

**Uniform Disposition of Unclaimed Property Act**

With the growing popularity of state unclaimed property statutes as a new source of state revenue in the 1950's, uniformity of such laws became a necessity, as controversies between states over conflicting claims to property developed. For example, if a corporation abandons credits it has based on a trade relationship with a vendor, several states might attempt to claim custody. The credits could be covered under the law of the state where the company was incorporated, or the state where the corporate headquarters was located. In addition, any state that was doing significant business with the corporation might claim the property.

In 1954, the Uniform Disposition of Unclaimed Property Act (the "Uniform Act") was introduced to unify the state statutory scheme of escheatment. The Uniform Act was last amended in 1995. Under the Uniform Act of 1995, every company and banking institution must file annual unclaimed property report with the states and make a good-faith effort to find the owners of their dormant accounts. The Uniform Act attempts to prevent multiple state claims for property by designating the last known address of the owner as the basic test of jurisdiction. Thus, under the Uniform Act, if two states claim custody of the same property, the law of the state of the last known address of the owner governs. If property is abandoned, the state must establish its right to the property by proving that the property is located within its territorial limits.

In the case of real property, this is not difficult. However, because the states' escheat statutes also apply to intangible abandoned property, a state must establish that it has sufficient contacts with intangible property before escheat. Generally, if the property is considered to have a situs within the state, it is subject to escheat. The Uniform Act establishes a period for a presumption of abandonment for most types of property. For example, in California if the property is unclaimed for three years after it becomes payable or dispersible, the escheat laws apply. Presently, forty-two states (including California, New York, Texas, and Florida) and the District of Columbia have enacted some version of the Uniform Act.

Delaware receives a significant portion of escheated property, notwithstanding that its population is but 800,000. This is because a large percentage of corporations incorporate in Delaware and where the address of the owner can no longer be located under the escheat laws, a party forwards the abandoned property to the company's state of incorporation.

**Factors Causing the Recent Spike in Abandoned Property**

The passage of Sarbanes-Oxley corporate reporting law, changes in the insurance business and other changes in corporate governance have dramatically increased the amount of "unclaimed property" money being collected by all 50 states, according to state treasurers.

The passage of Sarbanes-Oxley Act in 2002 forced companies to tighten their auditing processes. Section 302 of the Act requires CEO's and CFO's to certify the accuracy of the company's financial statements filed with the SEC. The first step in improving financial reporting was Section 404 which requires that all companies perform an assessment of their internal controls. Adequate internal controls are a responsibility of company management. In addition, the company's CPA must report on and attest to management's assessment of the internal controls. Further, fines between $1 to $5 million and a prison sentence between 10 to 20 years are prescribed for non-compliance due to "sloppiness" or "willfulness" in Section 906 of the Act. Given the harsh punishment for non-compliance, more and more companies are tightening their auditing processes and starting to hand over more unclaimed money to the government.

Other factors are also contributing to the rise in the amount of money being collected by the government. According to Associated Press, Banks, for example, must transfer to state governments the money in any account whose owner has fallen out of touch with the institution for anywhere between three to five years, depending on the state.

A change in the insurance business is also a contributing factor. Today many mutual insurance companies have reorganized their structure and have become publicly traded companies. As a result, though many don't realize it, policyholders have received billions of dollars in stock and cash from insurers' initial public offerings.

In addition, some state treasurers express the fact that Americans are now more likely to mover from city to city resulting in them opening accounts but them forget them when they move.

**Escheatment Audit**

How does a state enforce its escheatment law? Generally, through audits. Audits are usually handled by the state treasurer's office or controller. The scope of the audit usually goes back several years. The auditors usually request the following: (1) chart of accounts; (2) general ledger/trial balance; (3) annual report; (4) journal entries; (5) bank reconciliations; and (6) accounting policies.

**Business to Business Exception**

Under the business-to-business exception, outstanding balances between vendors may be deemed a duplicate payment. Accordingly, under this exception there is no unclaimed property to turnover. Nine states recognize the exception: Illinois, Iowa, Kansas, Maryland, Massachusetts, North Carolina, Ohio, Virginia and Wisconsin. However, application of the exception has proven a problem. Under the ruling of

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Texas v. New Jersey, should one state not require unclaimed property be turned over, but another state does require turnover, the later state would control for turnover of the property. Thus, only those cases where both states do not require turnover is the credit professional free not to escheat.

**Risks of Not Escheating**

Most states require businesses to review their records to determine whether any property has been unclaimed for the dormancy period and to make an annual report. As an owner of unclaimed property a vendor has a legal responsibility to exercise appropriate due diligence to track abandoned property, take appropriate steps to locate its rightful owner and, assuming the owner cannot be located, report that property to the state in accordance with its reporting guidelines. The state escheat statutes have harsh provisions for parties that fail to timely report or turnover unclaimed property. In addition to interest that runs from period that the property should have been turned over, the state may assess fines, penalties and damages.

To avoid negative consequences of non-compliance, vendors need to maintain systems, controls, policies and procedures that adequately and effectively identify, age and separately account for escheatable and potentially escheatable property and report such property in a timely fashion.

Most businesses use spreadsheets to manage and track unclaimed property. This is not a bad method of management but it may become complicated down the line due to the countless items, processes and regulations that must be factored into the process of maintaining compliance with each state's unclaimed property legislation. If a vendor does business in multiple states, the vendor may be required to file unclaimed property report and remit funds to more than one state. Unfortunately, each state has its own set of rules and unclaimed property legislation, making compliance even more challenging. California, for example, requires escheatment to the state after three years of abandonment.

As an alternative to keeping spreadsheets, there are numerous software products that are designed specially for managing unclaimed property. Many of these software products will automatically track dormancy periods and state reporting timeframes and will remind the user that a particular action is pending. Furthermore, businesses do not have to be concerned about changes in the legislation as these solutions are supported by organization that make considerable investment in remaining abreast of changing legislation and ensuring that those changes are incorporated into the next release of the software.

Note that if a business chooses to outsource escheatment related matters the business may still be fully responsible for the performance of the vendor complying with the law and responsible for avoiding conflicts of interest as well.

**Steps to Protect Against Escheatment Claims**

A credit executive should develop a game plan, and consider the following:

**Step One: Determine the Situation**

- Review past compliance. Has the company every reported unclaimed property? If so, what, when, and where?
- Has the company every been subject to a state unclaimed property audit? If so, what were the results and what states were part of the audit?
- Are there any subsidiaries to be included?

Has the company made any recent acquisitions that should be included?

**Step Two: Determine Eligible Property**

- Does your company have some of the property types covered by most states? These include:
  - vendor checks,
  - payroll checks,
  - customer credits,
  - refunds,

  gift certificates,
  common or preferred stock,
  long-term debt, etc.
- What states are represented among the names and addresses to be reported?

If this is an initial filing, what about years that may not be on the books?

**Step Three: Perform the due diligence**

- What due diligence is required by state? Specifically, focus on:
  the minimum dollar amount, timing, method and content notice. The accompanying table shows the minimum dollar amount and timing for payroll and vendor payments by state.
- What about operational due diligence? This might include developing a strategy to minimize unclaimed property liability and reviewing potentially reportable items.
- Prepare the due diligence letter. This should include the following important elements:
  response deadline
  identification number and amount
  property type/reason
  instructions for claiming

**Step Four: Prepare Reports and Remittances**

- Identify due dates for states
- Prepare a cover sheet with signature
- Use the proper media, paper, diskette, etc.
- Use the proper report format
- Include the remittance, which might be a check, wire transfer etc.

**Step Five: Filing Reports and Remittances**

- File on time to avoid penalties and interest
- If you get an extension, get it in writing. Only some states will grant them.

**Step Six: Follow up…Reconcilement**

- Reconcile general ledger to detail
- Reconcile paid items to appropriate accounts/divisions
- File any necessary holder reimbursement claims with the states
- Establish a filing system for reports and work papers.

**Step Seven: Celebrate**

Credit professionals can also look to

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the following web sites for guidance:

- National Association of Unclaimed Property Administrators - www.unclaimed.org
- The Freedom Group - www.freedomgroup.com
- Recap - www.recapinc.com

**Turning Over the Property**

If the vendor decides to turnover the property to the state, most state statutes provide that the vendor should turn the property over to the State Controller. Most legislation requires the vendor to make reasonable efforts to notify the owner of the property by mail that the owner's property will escheat to the state. The notice should be mailed generally not less than six months before the property is to be turned over to the State Controller.

Depending upon the nature, all unclaimed property should either be delivered to the State Treasurer or Controller. When the unclaimed property is cash, delivery is made to the State Treasury; all other types of personal property go to the Controller.

The party delivering the property is relieved and held harmless by the state from all claims regarding the property. No action or lawsuit may be maintained against the holder of the property.

Prior to delivery, the holder must furnish notice to the Controller. At a minimum notice must include: The amount of cash, or nature or description of other personal property; the name and last known address of the person entitled to the property; and reference to a specific statutory provision under which the property is being transmitted.

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cured basis; and (3) the additional post-preference unsecured credit is unpaid, in whole or in part, as of the date of the bankruptcy petition.

Here, the case involved a unitary transaction, unlike most "new value" cases. The contract was for a single machine delivered in its component parts due to industrial manufacturing necessities. The contract did not contain a conditional delivery provision whereby the debtor would have to make certain payments by an assigned delivery date. The creditor only had to make certain that they would not "get ahead" of the debtor in delivering the parts of the machine for the obvious substantial production costs of the component parts.

The component parts delivered by creditor subsequent to the date of the preference payment provided nothing more to the debtor than what was commercially required of the creditor under the terms of the contract. If the creditor did not deliver those component parts, creditor would have been in breach of its commercial contract with debtor. This was a single contract for the purchase and delivery of one machine, not a series of contracts. Thus, creditor did not provide anything more than what was required of it under the contract agreement with debtor.

In conclusion, deliveries stemming from a contract for a single good that requires multiple deliveries of the good's component parts for assembly at its destination that are made after buyer files bankruptcy, do not constitute "new value" for the seller.

## *LIEN LAWS, BANKRUPTCY PREFERENCE LAWS AND PREEMPTION UNDER THE SUPREMACY CLAUSE OF THE U.S. CONSTITUTION*

(Continued from page 1)

In response, the debtor asserted that the New York lien law conflicted with federal bankruptcy laws. The debtor argued that, as a result of the conflict, the New York lien law was preempted under the Supremacy Clause of the U.S. Constitution. The Supremacy Clause provides that to the extent federal and state laws conflict, the state laws are invalid.

In ruling on the defendants' motions for summary judgment, the court concluded that defendants were entitled to judgment in their favor because New York lien law created a statutory trust, which required that the funds received by a general contractor for the improvement of real property be held in trust for the benefit of the subcontractors. Therefore, the funds were not property of the debtor's estate. The court's ruling gives creditors another weapon their arsenal against the war on preference recoveries.

## *NOTARIZE THOSE PERSONAL GUARANTYS TO AVOID LITIGATION*

(Continued from page 3)

ing expert who stated that he could not rule out that the signature was not a forgery. The appellate court reviewed the signature on the guarantee and handwriting samples. The court considered the testimony of the vendor's credit professional as to the importance of the guarantee in extending credit. The appellate court concluded that the signature was that of guarantor, and affirmed the trial court.

The court's ruling underscores that personal guarantees can be used as a second pocket to collect where the corporate customer fails to pay. However, the court's ruling also underscores that credit professionals should take every step to make enforcement of a personal guarantee as simple as possible. This includes having a notary witness the principal signing the guarantee. Otherwise, you may face litigation to collect on the guaranty.

## *SUPREME COURT REFUSES TO CONSIDER APPEAL RE THE STATE PREFERENCE ACTION: IS THE STATE PREFERENCE ACTION COOKED?*

(Continued from page 4)

Besides California, the following have also adopted state preference laws: Colorado, Delaware, Georgia, Indiana, Iowa, Kentucky, Maryland, Missouri, Montana, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Washington and Wisconsin.

### C. *Sherwood Partners v. Lycos: The Out-of-Court Liquidation and State Preference Suit in Action*

The state preference suit in *Sherwood Partners* arose from an agreement between the debtor, Thinklink Corporation, and the vendor, Lycos, Inc. The debtor defaulted on the agreement and, through negotiations; the debtor paid the vendor $1 million.

#### 1. The Assignee Sues the Vendor for a Preference under State Law

Approximately two months after the debtor paid the vendor $1 million, the debtor made a general assignment for the benefit of creditors to Sherwood Partners, a consulting firm, the assignee. The assignee shut down the debtor's business and liquidated its assets, and sued the vendor in state court to recover the $1 million payment as a preferential transfer.

#### a. Removal of Preference Action to the Federal District Court

The vendor removed the preference suit from state court to federal court on diversity grounds and moved to dismiss the preference suit. The vendor argued that the state preference statute was preempted by the federal Bankruptcy Code's preference statute, and, therefore, the preference suit should be dismissed.

#### 2. The District Court Denies Vendor's Motion to Dismiss and Grants Preference Judgment

The vendor filed a motion with the district court to have the preference compliant dismissed. The district court denied the vendor's motion to dismiss, and eventually granted judgment in favor of the assignee for $1 million. The vendor appealed the decision to the Ninth Circuit Court of Appeals.

#### 3. The Ninth Circuit Court of Appeals Reverses the District Court and Remands the Case for Dismissal

In a split decision, the Ninth Circuit compared the preference avoidance powers granted to an assignee under the state's preference statute with the avoidance powers of a trustee under the Bankruptcy Code. The Ninth Circuit determined that the assignee appointed pursuant to the state preference statute is given new avoidance powers by virtue of his position and the federal Bankruptcy Code preempts the state preference statute.

#### a. The Bankruptcy Code Preempts the State Avoidance Statute

Key to the Ninth Circuit's ruling that an assignee may not prosecute preference actions under California's state preference statute is whether the federal bankruptcy preference statute preempts the state preference statute. The court ruled:

> "Congress' intent to supersede state law altogether may be found from a 'scheme of federal regulation . . . so pervasive as to make reasonable the inference that Congress left no room for the Sates to supplement it . . . There can be no doubt that federal bankruptcy law is 'pervasive' and involves a federal interest 'so dominant' as to 'preclude enforcement of state laws on the same subject . . ."[2]

The court found that the state statute granted the assignee new avoidance powers as a result of the assignee's position.

The court further noted that:

> "One of the major powers the [Bankruptcy] Code gives the trustee is the power to avoid preferential transfers. . . [and] may be exercised only under the supervision of the federal courts. Federal law protects creditors—particularly out-of-state creditors like Lycos—from the trustee's possible conflicts of interest and other possible sources of self-dealing. [citation omitted]."

The court held that the assignee's prosecution of preference actions under state law was inconsistent with the federal bankruptcy code and was therefore preempted.

#### b. Assignee Appointed by Debtor a Problem

An ABC permits the debtor's officers to select the assignee, unlike a bankruptcy trustee in a Chapter 7 liquidation, where a trustee is selected from a panel of trustees by the Office of the United States Trustee, which is an adjunct of the Justice Department. In *Sherwood Partners*, the Ninth Circuit court was concerned that an assignee was not subject to U.S. Trustee or court oversight. The Ninth Circuit found that absent this oversight, creditors were not assured that an assignee may act in the best interests of creditors.

#### c. No Double Recovery Under Sate Preference Law and Federal Law

The Ninth Circuit also was concerned that an assignee could recover preferences under state law, distribute the proceeds, yet still face a bankruptcy proceeding. In this setting, a bankruptcy trustee could not also pursue preference claims against the same creditors.

#### 4. The US Supreme Court Refuses to Consider Assignee's Appeal From Ninth Circuit

The US Supreme Court refused to grant certiorari to consider the Ninth Circuit's ruling. The consequence of the Supreme Court's ruling is that a vendor may now contend that the Ninth Circuit's decision is now binding on federal courts within the Ninth Circuit. The vendor may also contend that federal courts outside of Ninth

(Continued on page 9)

## *SUPREME COURT REFUSES TO CONSIDER APPEAL RE THE STATE PREFERENCE ACTION: IS THE STATE PREFERENCE ACTION COOKED?*

(Continued from page 8)

Circuit should be persuaded by the court's decision.

**D. *Goodbye to State Preference Actions?***

**1. Constitutionality of State Preference Actions**

The Ninth Circuit found that an assignee may not pursue a preference action in a state court liquidation as the federal bankruptcy code preempted the state court preference statute.

**a. Removal to Federal District Court?**

As preference actions in ABC's are generally commenced in state courts, a vendor seeking to invoke the *Sherwood* decision may need to consider removing the preference action to the federal district court. A vendor may have a case removed to federal court on the grounds of federal-question jurisdiction. On the other hand, a state court may adjudicate issues of federal preemption.

Accordingly, either way, a defense under *Sherwood Partners* may be raised.

**2. Good News for Vendors (Facing Potential Preference Claims), But What of Preference Claims Against Insiders?**

Vendors that have received meaningful payments during the preference period should be pleased with the *Sherwood Partners* decision. But what of the insiders that may have received preference payments? If insiders received meaningful payments from the debtor during the preference period, is the assignee under a duty to disclose to creditors such payments?

**a. Vendors may be Better Served in ABC than Chapter 7**

Depending on the vendor's view, whether they received meaningful payments during the preference period, may shape their decision to support the assignment, as opposed to move for an involuntary bankruptcy petition.

**b. Does Assignee Have a Fiduciary Duty to Investigate Preferential Transfers and Disclose the Preference Analysis to Vendors?**

Under an ABC, an assignee is hand-picked by the debtor's officers. An assignee holds the preference powers and the financial information as to which parties received payments during the preference period. Does an assignee, who has a fiduciary duty to creditors, have a responsibility to conduct a preference analysis? If the assignee prepares a preference analysis and determines there are significant preferences, both to vendors and insiders, does the assignee file bankruptcy, thereby losing his assignment?

**3. Prejudgment Remedies may Have a Greater Appeal for the Vendor**

States generally have prejudgment remedies available for creditors where a debtor fails to pay. Those prejudgment remedies may include attaching a debtor's assets. Should the creditor's attachment occur 90 days prior to the debtor's bankruptcy, the creditor would like face a preference suit. If the debtor files an ABC instead of a bankruptcy, the attachment may not be challenged as a preference. Given this distinction between out-of-court and bankruptcy liquidations as a result of the *Sherwood Partners* decision, a vendor may be inclined to pursue a prejudgment remedy if it anticipates that the debtor may assign its assets.

**4. More Involuntary Petitions May be Filed by Vendors so Insider Preference Claims May be Pursued**

If the debtor assigns its assets under an ABC, vendors may respond by filing an involuntary bankruptcy petition to preserve possible bankruptcy preference claims against insiders. An eligibility requirement to file an involuntary petition is that the petitioner be a creditor holding an unsecured claim aggregating $12,300. If a debtor has greater than 12 creditors, then three petitioning creditors' claims must aggregate $12,300. The petitioner's claim must not be subject to a bona fide dispute, and the debtor must generally not be paying its debts when due.

**a. The Abstention Doctrine may be Undermined**

Even if the involuntary petition is found to be properly filed, the bankruptcy court nevertheless may exercise its discretion to abstain from entering an order for relief and dismiss the petition. The grounds for dismissal are that it would be in the best interests of the creditors and debtor, or that creditors have adequate remedies under state law, including where state court remedies would promote a more efficient means of administering the debtor's assets. Given the *Sherwood Partners* decision, petitioning creditors facing an assignee's abstention motion may have a compelling argument for a bankruptcy jurisdiction: the assignee cannot pursue preference claims, especially if such claims exist against insiders, the parties that selected the assignee.

**5. State Must Amend Preference Statute**

The state legislature will need to amend the preference statute to address the court's concerns.

***The Lesson for the Credit Professional***

Debtors, trustees, litigation trustees, and creditors' committees among others seem more intent than ever to pursue preference actions in federal bankruptcy cases. Given this bent to pursue bankruptcy preferences, a vendor may be pleased with the *Sherwood Partners* decision, especially if they have received meaningful payments from a customer during the preference period that elects to liquidate their assets under state law. Vendors facing preference demands and suits under state law may consider using the *Sherwood Partners* as an absolute defense to the state court preference claims, and the US Supreme Court seems to agree.

Guest Column

## *BANKRUPTCY PREFERENCE CLAIMS: HOW CREDIT PROFESSIONALS CAN AID IN THEIR DEFENSE AND MINIMIZE FURTHER LOSES*

(*Continued from page 2*)

that can be considered.

**Collection and application of customer (debtor) payments**

The timing and method of payments (transfers) can be critical to the defense of a preference claim. In the case of Barnhill v Johnson, 503 U.S. 383 (1992) the court held that " If the debtor pays by check, then the transfer is made when the check clears the bank." Although not specifically detailed in 11 U.S.C., payments received electronically; i.e., EFT or EDI, generally are considered "paid" on the date received by the creditor. Creditors utilizing lockboxes and/or receiving payments electronically might appear to have a timing advantage over those who still receive customer payments through a post office box and manually prepare daily or periodic deposits into a local bank account. However, placement of lock boxes in relation to customer concentration is important in the reduction of payment mail time. Phoenix-Hecht mail studies should be utilized prior to initial placement of lockboxes and credit executives should frequently review customer payment patterns to ensure mail times are being kept to a minimum.

The implementation of The Check Clearing for the 21st Century Act (Check 21) on October 28, 2004 was expected to vastly improve the manner in which banks clear checks. Historically, paper checks have been physically moved from bank to bank within the Federal Reserve System. This check clearing process was not only costly but, time consuming. Often, the clearing process could take several days. In the aftermath of 9/11, it became clear to financial institutions that physically moving checks severely impeded the flow of funds within U. S. commerce.

Check 21 allows banks to clear checks through the exchange of digital images of checks. According to cash management officials at major banks, checks received through a lock box collection system should clear (be paid) within twenty four (24) hours. For the businesses not utilizing lockboxes for the collection of customer payments, once customer checks are deposited, the clearing time should be within twenty four (24) hours. Credit executives and treasury managers should make sure their lock box service providers are in compliance with Check 21 provisions.

The "payment date" or check clearing date becomes critical when a payment history analysis is prepared to aid in the defense of a preference action. Typically, the attorney filing a preference action prepares an analysis showing the history of his or her client's payments to creditors. Such analysis generally uses the check date as the "date of payment." However, defense attorneys more often will use the date that the debtor's check was "paid," or cleared as the payment date. Thus, in calculating the period from a creditor's invoice date until the "payment date," a discrepancy of several days can result between payments analysis prepared by plaintiff and defense. Such discrepancies can make the difference of whether a debtor's payment falls within the 90 day "preference period." Regardless of the method in which customer payments are received, it is incumbent upon the credit executive to see that payments are applied to customer accounts on the same day they are received.

**Record retention**

While the temptation to periodically "clean out" customer files to reduce requirements for physical filing space may be strong, keeping historical records to document the business relationship between debtor and creditor becomes more important in defending a preference action. Available technology provides credit professionals the tools with which to store large quantities of documents digitally, rather than keeping hard copies in file cabinets.

Records retained should include, but not be limited to the following:

- Credit application(s) received from debtors
- Credit reports and/or trade references obtained on debtors
- Contracts and/or agreements documenting sales relationships with debtors
- Purchase orders received from debtors
- Invoices issued to debtors
- Copies of checks, wire transfer confirmations, EFT receipts or any other form of payments received from debtors
- Aged accounts receivable trial balance on debtors
- Copies of any collection notices, correspondence or records of collection calls made to debtors
- Copies of any correspondence, electronic or hard copy, between sales personnel and debtors
- Credit and Collection policies and procedures

**Policies and Procedures**

Ask most credit executives to name six companies whom they believe have the most comprehensively written and administered credit and collection policies and procedures and they will likely name nationally recognized Fortune 100 or 500 corporations. Surprisingly, in this case, bigger doesn't always mean better.

During 2005 and 2005, I was retained to aid in the defense of more than a dozen bankruptcy preference actions. These claims against Fortune 100 and 500 unsecured trade creditors totaled more than $10 million. In reviewing internal documents of these firms related to the relationship with debtor (customer) companies, I was surprised to learn that a number of them did not have formal, written policies and procedures governing their credit and collection functions. You may ask, "How is this possible?"

Historically, many corporate executives, especially those in sales, have never viewed the credit and collection function within their companies as a positive contribution to sales and profits.

Thankfully, through the educational and training programs of such organizations as the National Association of Credit Management (NACM), such old-fashioned attitudes are changing. Credit executives of more and more companies are being recognized as important, contributing members of the management team. And, the importance of well-conceived, written and administered policies and procedures is gaining momentum in the corporate community. Much of the momentum has been generated by the implementation of internal processes required by §401-409 of the Sarbanes-Oxley Act, which govern "enchanced financial disclosures" regarding a firm's annual financial reports. Included in these sections

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Guest Column

## *BANKRUPTCY PREFERENCE CLAIMS: HOW CREDIT PROFESSIONALS CAN AID IN THEIR DEFENSE AND MINIMIZE FURTHER LOSES*

(Continued from page 10)

are requirements for periodic reporting, management assessment of internal controls and enhanced review of periodic disclosures by issues.

A policy is usually considered a general statement of how a company does business with all customers, while a procedure is regarded as an outline of how daily functions are carried out in applying the company's policy.

Policies and procedures serve as the basis for continuity and consistency within an organization. They also serve as training documents for all employees.

All top executives within an organization must support the implementation and ongoing administration of effective policies and procedures.

Consistent administration of policies and procedures are important in documenting the "ordinary course" of business relationship between creditor and debtor.

**Training**

Ongoing, consistent training of personnel is important within an organization to insure adherence to policies and procedures. To be effective and successful within their job functions, corporate personnel must first fully under-stand the effect of their jobs and how their performance can impact the company's overall success and profitability. Second, ongoing training is important to allow personnel to expand their knowledge and skills base, thereby, enabling them to be more productive and more valuable to their employers.

In competitive sports, you frequently hear the phrase, "a good defense is the best offense." I believe this theory can be effectively applied to business and more specifically to a company's credit and collection functions. Too often, credit executives become complacent and end up as "care takers," maintaining the status quo, rather than being proactive by looking for ways to improve internal processes and helping their staff members improve their performances.

Consistency in record keeping, administration of credit and collection policies and procedures, customer relations and process improvement can make positive contributions to the successful defense of bankruptcy preference claims and reduce a company's bad debt losses.

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*Mr. Dorman Wood is president of Dorman Wood Associates, Inc. and advises creditors as to their preference defenses, including serving as an expert witness in such actions.*

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## *LONGSTANDING BUSINESS RELATIONSHIP MAY NOT PROVIDE A SAFE HARBOR TO VENDORS UNDER PREFERENCE EXCEPTION*

(Continued from page 3)

was sufficient to show that the relationship was unstable.

Even if the relationship had been stable, the relationship deteriorated when the supplier attempted to place the debtor on a payment schedule. The required weekly payments were differed from prior practice because the payments were not related to any particular invoices. Placing a debtor on a payment plan indicated a deteriorating creditor-debtor relationship.

Because the relationship between the supplier and the debtor lacked stability due to inconsistent payment terms and an attempt to put the debtor on a payment plan, the six payments made during the preference period were not according to ordinary business terms. Although forbearing creditors of long standing often keep debtors out of bankruptcy, such longstanding business relationship does not always provide a safe harbor to the creditors.

# RECENT ENGAGEMENTS AND ACTIVITIES

## *Blakeley & Blakeley LLP Recent Engagements and Activities for Winter 2005*

*Blakeley & Blakeley continues to represent its vendor clients in the areas of creditors' rights, bankruptcy, commercial litigation and collection, preference defense, credit documentation, and out-of-court workouts.*

◊ Scott spoke to the **National Hardwoods Credit Group** in San Diego regarding the **Bankruptcy Reform Act of 2005.**

◊ Scott spoke to the **Vulcan Corporation** in Phoenix regarding the **Sarbanes-Oxley Act** and **Credit Applications.**

◊ Scott spoke at the **East Coast Credit Conference** in Maryland regarding **Escheatment** and **the Bankruptcy Reform Act of 2005.**

◊ Scott spoke on a teleconference to **IOMA** members regarding the **Bankruptcy Reform act** and **Credit Enhancements.**

◊ Scott spoke to **NACM** members in Chicago regarding the **Bankruptcy Reform Act of 2005.**

◊ Scott spoke to **CFDD** members in Los Angeles regarding the **Bankruptcy Reform Act of 2005.**

◊ Scott spoke to **Orange County Credit Professionals** regarding **Credit Applications.**

◊ Scott spoke to the **North American Retail Industry Group** in Las Vegas regarding **Creditors' Rights** and the **Bankruptcy Reform Act of 2005.**

◊ Scott and Brad gave a webinar to **Ferguson Corporation** regarding the **Bankruptcy Reform Act of 2005.**

◊ Scott and Brad gave a webinar to **Owens Corning** regarding the **Bankruptcy Reform Act of 2005.**

◊ Scott gave a webinar to **Georgia Pacific** regarding **Consignments.**

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